Credit Cards

by Sophia

WHAT'S COVERED

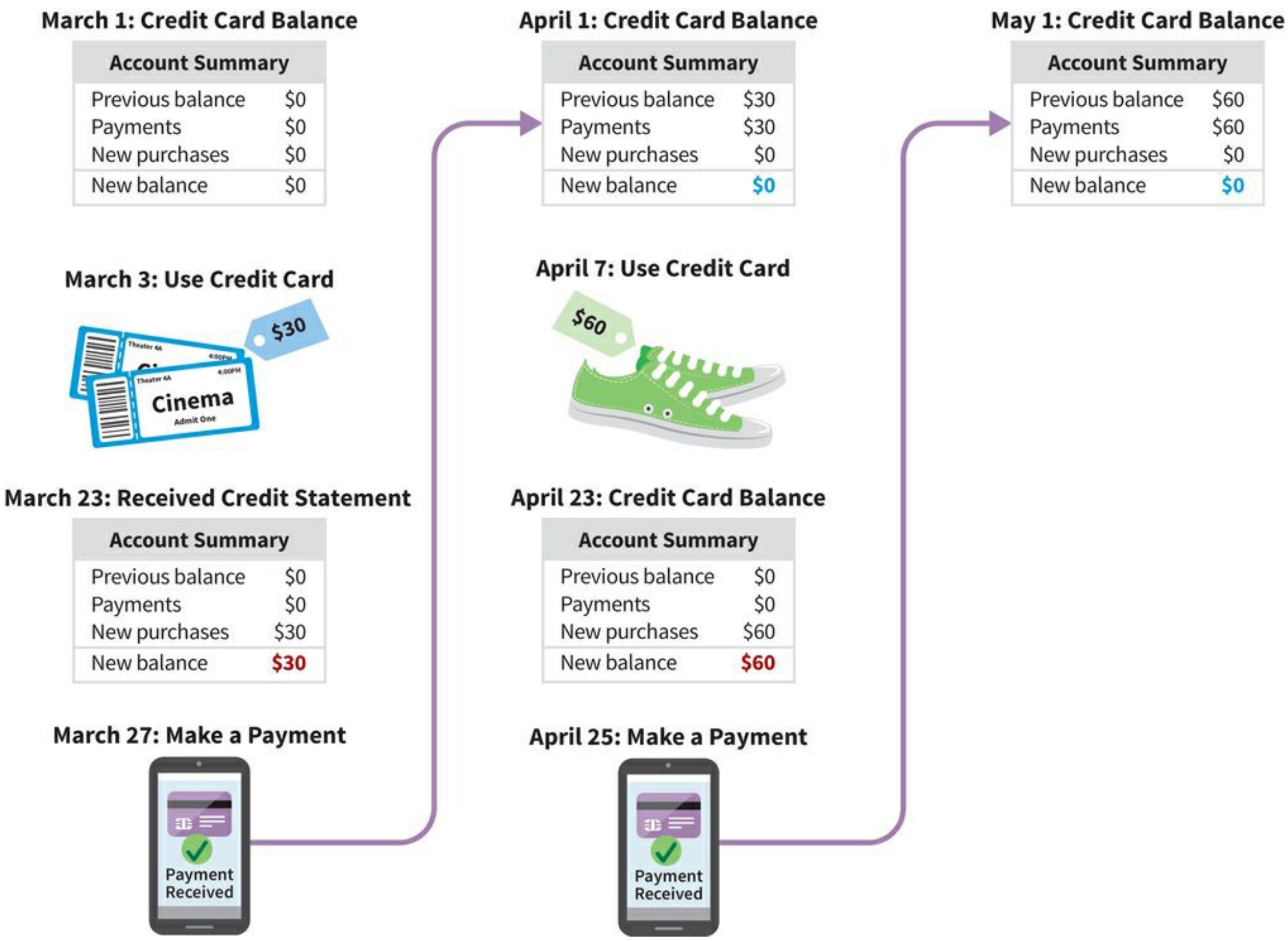
In this lesson, you will learn about the role of credit cards as a financial management tool. You will explore how you can use your problem solving skills to determine if a credit card is right for you and how it could make you more productive. Specifically, this lesson will cover:

1. Characteristics of Credit Cards

Credit cards are different in that they are not a traditional loan. Credit cards are a type of a line of credit. Some consumer advocates refer to credit cards as revolving loans or as **open-end credit**. A line of credit is a type of loan that the borrower can:

- Access at any time.
- Make adjustable payments on the loan to decrease or pay off the balance.
- Borrow the money again without having to reapply for a loan from the lender.

As the following illustration shows, a credit card loan can be paid off in full each month and then borrowed in full the following month without having to seek lender approval.



Problem Solving: Skill in Action

In the past, Anne had some unanticipated expenses come up and no way to cover them. She ended up borrowing money from her mom, but she knew that was not something she wanted to do again. She used her problem solving skills to look at the advantages and disadvantages of low-interest credit cards. She determined that opening a card offering her 0% interest and no fees for 6 months was a good idea given her financial situation. She felt better knowing she was ready in an emergency.

TERMS TO KNOW

Credit Card
A line of credit or a type of loan that the borrower can access at any time, make payments on the loan to decrease or pay off the balance, and borrow the money again without having to reapply for a loan from the lender.

Open-End Credit
Preapproved loan between borrower and financial institution that may be used frequently up to a certain credit limit and can be paid back earlier.

1a. Understanding Credit Card Terms

When applying for a credit card, you can pay off the credit card in full each month or carry a balance from one month to the next. You should always try to pay off the total balance on a card each month. Otherwise, the interest payments can really add up!

IN CONTEXT

Let's say you plan to carry a balance on your credit card each month as you work to pay it off. In this case, you must consider the Annual Percentage Rate (APR) of your selected credit card – as well as any required fees – extremely carefully. Let's say you have a $1,500 balance on a credit card that charges a 23% interest rate. Let's also assume that the minimum payment on the credit card is calculated as 4% of the outstanding balance or $25, whichever is greater.

- If you make the minimum payment every month, it will take more than 6 years to pay off the bill!
- This means that you'll end up paying the credit card company more than $1,000 in interest in addition to the $1,500 that you borrowed.
- Instead, if you selected a credit card with a rate of 15%, you would pay off this same bill in 5 years and pay about $500 in interest.

Of course, if you carry a balance, you should try to make the highest monthly payment possible. If you could pay $135 per month, rather than the minimum payment, and the interest rate is 15%, you will pay the loan off in just 1 year and only pay about $125 in interest.

1b. Types of Credit Cards

Like most consumer products and services, credit cards come in all sorts of packages. Although most people first think of MasterCard®, Visa®, and Discover®, it's important to remember that there are other types of credit cards.

- Hotels, gas companies, and airlines issue credit cards, most of which are co-branded with a company like Visa®.
- Some credit cards are really **travel and entertainment cards**, such as American Express® and Carte Blanche®, which typically require cardholders to pay off their balance on a monthly basis (although American Express issues both credit cards and travel and entertainment cards).
- If you plan to pay off your credit card balance each month, you may want to consider **reward credit cards**, which provide benefits linked to how much the card holder purchases with their card. These benefits can include cash back, airline and hotel travel points, and other valuable benefits. These types of credit cards generally have higher interest rates and fees, as illustrated in the following column chart.

If you plan to carry a monthly balance, reward credit cards may not be a good choice because of their higher interest rates and fees. However, if you don't carry a balance, reward cards may be just as affordable as regular credit cards.

WATCH

What type of credit card might be right for you? As you think about your answer, watch this video about one consumer's preferences when it comes to credit cards.

TERMS TO KNOW

Travel and Entertainment Cards
Credit cards that typically require cardholders to pay off their balance on a monthly basis, such as American Express® and Carte Blanche®.

Reward Credit Cards
Credit cards that provide benefits linked to how much is purchased with the card. These benefits can include cash back, airline and hotel travel points, and other valuable benefits.

2. Credit Card Payments

2a. Calculating Monthly Minimum Payments

Calculating a minimum monthly payment is really easy.

- For example, if you have a $1,500 balance on a credit card with a 23% APR, you would multiply this by the multiplier used by your credit card issuer, which typically ranges between 2% and 4%.
- Let's assume it's 4%, so $1,500 × 0.04 would be $60, which is the minimum payment for the next month.
- As you pay down the outstanding balance, the minimum payment also decreases, which makes the loan repayment period longer and costs you more money!

BIG IDEA

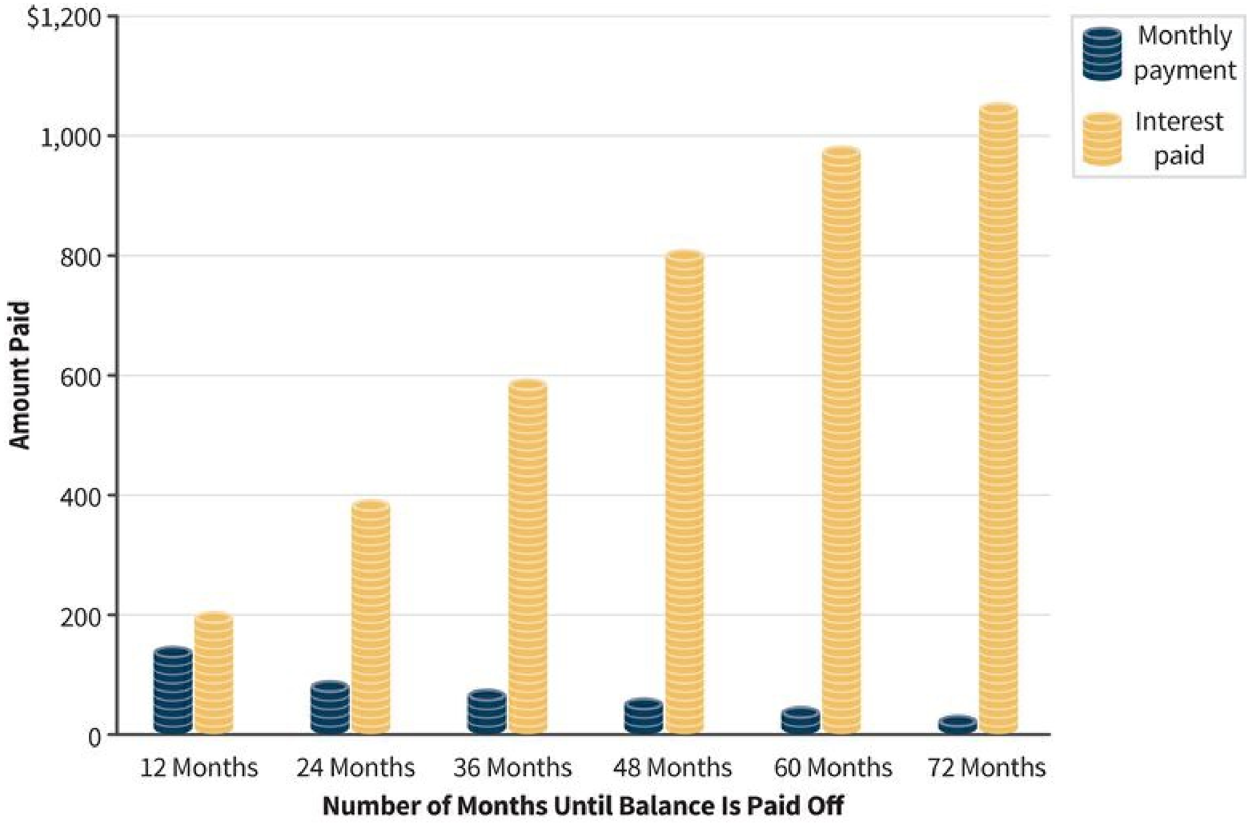
This is why you never want to be in the habit of making only the minimum payment.

2b. Calculating Monthly Interest

If you want to know how much you are paying in interest each month:

1. Take the 23% APR from the preceding example and divide this by 365 (0.23 ÷ 365); this equals 0.063%, which is the daily interest rate applied to outstanding balances.
2. Multiply $1,500 by 0.063% by the number of days in the billing cycle ($1,500 × 0.00063 × 30 days) and you get $28.35.
3. So, $28.35 of the $60 you are paying is interest. The remainder goes toward the balance.

The column chart below shows why you do not want to simply make the minimum payment. Assuming that you have a $1,500 balance, 23% APR, and your minimum payment is the greater of 4% of the outstanding balance or $25, then by only making the minimum payment it would take 6 years to pay it off! However, if you decided to pay about $141 per month, you would be able to pay off the outstanding balance in 12 months and save more than $800 in interest!



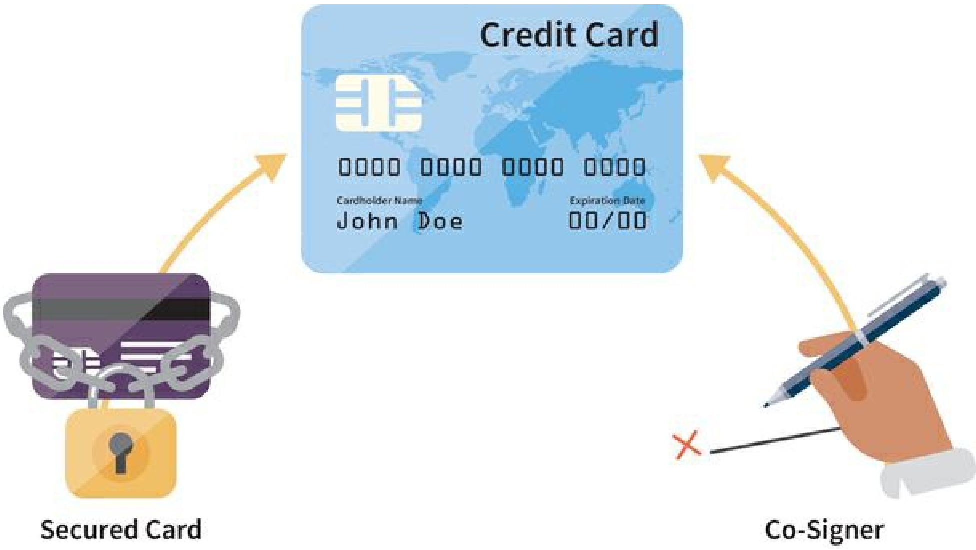
If you have a great credit score, many lenders will go out of their way to approve you for a new credit card. As a borrower with good credit, you can shop the market and find the best value possible. Many credit cards offer 0% introductory APRs and relatively low APRs after the initial period. If you do carry a balance, shopping around can provide significant savings.

Productivity: Skill Reflect

What are some strategies you could use to manage credit cards to avoid paying high-interest rates and fees? How can planning to manage your accounts lead you to be more productive and better equipped to reflect on your financial priorities?

3. Qualifying for a Credit Card

For many individuals, a credit card is the easiest way to establish a credit history. Ironically, many individuals are not able to qualify for a credit card because they lack sufficient credit histories and therefore do not have a credit score. However, there are several different ways in which an individual that does not have a credit history can still qualify for a credit card. Some credit card issuers have special student credit cards that are easier to obtain compared with a traditional credit card. If a student credit card is not available to you, the most common strategies, as shown in this illustration, are adding a co-signer or obtaining a secured credit card.



3a. Adding a Co-Signer

A **co-signer** is an individual, in addition to the borrower, who will be held responsible for repayment of the debt. If a borrower lacks a credit history and has a lower income, lenders are much more willing to approve the application if there is a co-signer with a strong credit history that guarantees prompt repayment.

TERM TO KNOW

Co-Signer
An individual, in addition to the borrower, who will be held responsible for repayment of the debt.

3b. Obtaining a Secured Credit Card

There is another way to obtain a credit card. Banks and credit unions offer financial products called**secured credit cards**, which provide a way for an individual to establish credit without having a co-signer. A secured credit card requires the borrower to deposit the full amount of the line of credit at the bank as collateral before the credit card is issued.

TERM TO KNOW

Secured Credit Card
Requires the borrower to deposit the full amount of the line of credit at the bank as collateral before the credit card is issued.

SUMMARY

In this lesson, you learned about some of the **characteristics of credit cards**. There are several **types of credit cards** to choose from including standard cards, entertainment cards, and reward cards. You can use your problem solving skills to compare and determine if one is right for you. For any card, it's important to **understand your credit card terms** to avoid hefty fees and interest. Making your **payments** is one of the most important aspects of owning a card.**Calculating monthly minimum payments** and **calculating interest** is straightforward, but you'll want to pay down more than your minimum monthly payment to avoid owing massive amounts of interest. Smart consumers often pay off their credit card balances in full each month. This ensures the card is a productive tool and not a detriment to a person's financial health.

Qualifying for a credit card primarily depends on your credit score and payment history. If you lack a credit history, two common strategies for obtaining a card are **adding a co-signer** and **applying for a secured credit card** that requires collateral up front. A co-signer is held responsible should the applicant default on payments, so know the risks before entering into such an agreement.

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